Supreme Court, U. S.
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In The

Supreme Court of the United States

October Term, 1976

No. 75-981

George C. McGee,

Petitioner,

v.

Commissioner of Internal Revenue,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

S. L. Greenberg
P. O. Box 3708
Beaumont, Texas 77704

Of Counsel

J. Martin Green
P. O. Box 3708
Beaumont, Texas 77704

Attorney for Petitioner

FIDELITY PRINTING COMPANY, HOUSTON

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George C. McGee,

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Commissioner of Internal Revenue,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered on September 26, 1975.

OPINIONS BELOW

The opinion of the Tax Court is printed in Appendix B hereto and is reported at 61 T.C. 249. The opinion of the Court of Appeals for the Fifth Circuit is printed in Appendix A hereto and is reported at 519 F.2d 1121.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was made and entered on September 26, 1975, (Appendix A) and Petitioner's Petition for Rehearing and Petition for Rehearing in Banc were denied on October 31, 1975. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

I. WHETHER A TAXPAYER WHO OMITTED FUNDS FROM HIS TAX RETURN AT A TIME WHEN SUCH FUNDS WERE NOT CONSIDERED TO BE TAXABLE INCOME CAN BE FOUND TO HAVE DONE SO WITH FRAUDULENT INTENT TO UNDERPAY TAXES.

II. WHETHER THE COMMISSIONER CAN SATISFY HIS BURDEN TO PROVE FRAUD BY CLEAR AND CONVINCING EVIDENCE BY INVITING THE TAX COURT TO MAKE INFERENCES OF FRAUD FROM STIPULATED FACTS.

STATUTES INVOLVED

The statutes involved are sections of the Internal Revenue Code of 1954. The civil tax fraud statute imposes a fifty percent (50%) penalty if the underpayment of tax is due to fraud. 26 U.S.C. Section 6653(b). Another section of the Code provides exceptions to the statute of limitations for *inter alia*, false or fraudulent returns with the intent to evade tax or willful attempt to evade tax. 26 U.S.C. Section 6501(c). These statutes are cited in full in Appendix C.

STATEMENT OF THE CASE

The United States Tax Court found that the failure of Petitioner to include embezzled funds in his income tax returns for 1957 through 1963, resulting in underpayment of tax for those years, was due to fraud with the intent to evade tax. The fifty percent (50%) tax fraud penalty was imposed under the statute set out herein, 26 U.S.C. Section 6653(b). The jurisdiction of the United States Tax Court was invoked under 26 U.S.C. Section 7442.

Most of the facts were stipulated by the parties and are not in dispute. The Taxpayer, a resident of Groves, Texas, was employed for the taxable years 1957 through September 15, 1963, as a Port Engineer in Port Arthur, Texas, by Gulf Oil Corporation (Gulf), and filed his returns with the District Director of Internal Revenue in Austin, Texas. As Port Engineer, Taxpayer had the authority and responsibility to inspect and contract for the maintenance and repairs on Gulf vessels. He employed marine contractors and service establishments to make repairs and supervised them on behalf of Gulf. Within the scope of his employment, he received, examined, initialed, and approved for payment various invoices and statements which he then delivered to Gulf for payment.

One marine contracting firm employed by Taxpayer was Port Arthur Marine Engineering Works (PAMEW). With the owner of PAMEW, Taxpayer embarked on a scheme involving padded, fictitious, and false invoices through which Gulf funds were embezzled, Taxpayer keeping from 5% to 50% of the embezzled funds.[1]

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals has decided a Federal question in a way in conflict with applicable decisions of this Court.

This is a tax fraud case in which a Taxpayer, who failed to report income at a time when such income was not taxable under a Supreme Court decision, has been penalized an additional fifty percent (50%) of the deficiency for not reporting it and paying tax on it. In *Commissioner of Internal*

[1] The Tax Court found the Taxpayer had embezzled the funds not reported (61 T.C. at p. 259) and in *Blaine S. Fox*, 61 T.C. 704, 718, fn. 10, referred to this case as involving "embezzled funds." The Court of Appeals apparently did not question this finding, although the concurring opinion intimates that this was not a "classic" embezzlement.

Revenue v. *Wilcox*, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752 (1946), the Supreme Court, to quote the Court of Appeals opinion in the instant case, "squarely held that embezzled money did not constitute taxable income." (App. A, p. A-5; 519 F.2d 1121 at 1124) Six years later, the Supreme Court in *Rutkin* v. *United States*, 343 U.S. 630, 72 S.Ct. 571, 96 L.Ed. 833 (1952), held that extorted money was income, limited the *Wilcox* case to embezzlement cases, but refused to overrule it. Accordingly, the *Wilcox* case was not overruled until 1961 in the case of *James* v. *United States*, 366 U.S. 213 81 S.Ct. 1052, 6 L.Ed.2d 246 (1961). A majority of the Supreme Court agreed in *James* that the *Wilcox* case should be overruled and that embezzled funds should be made taxable income for all tax years, even those years prior to its decision.

The Taxpayer did not and does not now dispute the holding of the Tax Court and the Court of Appeals that embezzled funds are taxable income. What is in dispute here, however, is the second main point of the *James* case, namely, that a taxpayer, as a matter of law, cannot be found to have willfully defrauded the Government of tax revenues by failing to report the funds he embezzled during tax years prior to the overruling of *Wilcox*. The *James* case, of course, was a criminal tax fraud case while the instant case is a civil tax fraud fifty percent (50%) penalty case, but the issue of fraudulent intent is the same in both types of tax fraud cases, the differences being the degree of proof required and the severity of the penalties imposed. *Estate of R. L. Adame* v. *C.I.R.*, 320 F.2d 811 (C.A. 5, 1963).

A majority of the Supreme Court held in *James* that intent to defraud the Government could not be proven, *as a matter of law*, and ordered the case dismissed. Two of the Justices (Mr. Justice Harlan and Mr. Justice Frankfurter) would have remanded the case for a fact hearing

on the issue of intent and one of the Justices, Mr. Justice Clark, would have affirmed James' conviction of tax fraud. But the other six members of the Court, concerned with the *ex post facto* implications of affirming the conviction or remanding the case for a hearing on the facts, held that James could not be proven, *as a matter of law*, to have willfully defrauded the Government of tax revenues in failing to report embezzled funds. That such was the holding is shown by the partial dissents of Justices Harlan, Frankfurter and Clark.

The facts in this case are indistinguishable from the facts in the *James* case and the Supreme Court's disposition of the *James* case controls here as to the tax years prior to 1961. The *James* case, like the instant case, involved a "kickback" scheme concocted by taxpayer and a co-conspirator, under which the employer's funds were paid to the co-conspirator who returned a portion of the funds to the taxpayer. The taxpayer was guilty of embezzlement of funds as a co-principal under state law. The Supreme Court in *James* found these facts to be "concededly" the same as the relevant facts in *Wilcox*.

The opinion of the Court of Appeals for the Seventh Circuit in *U.S.* v. *James*, 273 F.2d 5 (C.A. 7, 1959), reversed 366 U.S. 213, 81 S.Ct. 1052, 6 L.Ed.2d 246, attempted to distinguish *Wilcox* on the same grounds urged to the Court of Appeals by the Commissioner in this case: that *Wilcox* was limited to the cases involving the identical factual manner and mode used by Wilcox to embezzle funds, the "classic" embezzlement case. Since James was not a "classic" embezzler, but was only guilty of embezzlement because of the state law regarding co-principals and his "kickback" scheme, the Seventh Circuit felt it could uphold his conviction.

The Supreme Court, however, refused to distinguish *Wilcox* and stated in *James* that *Wilcox* was "a case whose *relevant* facts are concededly the same as those in the case now before us." *James* v. *United States,* 366 U.S. 213, 215, 6 L.Ed.2d 246, 251. The Supreme Court's holding that James could not be convicted because he could not be found to have had the requisite intent would clearly be unnecessary if the presence of a co-conspirator and a "kick-back" scheme in the crime of embezzlement had been sufficient to make the *Wilcox* decision inapplicable. Since *James* could not be found to have had the requisite intent as a matter of law, neither can the Taxpayer in this case for the years prior to 1961. The Court of Appeals for the Fifth Circuit was not at liberty to do what the Court of Appeals for the Seventh Circuit was reversed for doing in the *James* case.

II. The Court of Appeals has rendered a decision in conflict with the decision of other appellate courts on the same matter.

The decision of the Court of Appeals, that a Taxpayer may be proven as a matter of fact to have willfully defrauded the Government by failing to report embezzled income for the years prior to the Supreme Court decision in *James* v. *U.S.*, supra, is in conflict with the prior interpretation of the *James* case in decisions of the Court of Appeals for the Fourth Circuit, *U.S.* v. *Critzer,* 498 F.2d 1160 (C.A. 4, 1974), the Court of Appeals for the Eighth Circuit, *Nordstrom* v. *U.S.*, 360 F.2d 734 (C.A. 8, 1966), and the Court of Appeals for the Second Circuit, *Kahr* v. *C.I.R.*, 414 F.2d 621 (C.A. 2, 1969) and *U.S.* v. *Dawson,* 400 F.2d 194 (C.A. 2, 1968), cert. den. 393 U.S. 1023, 89 S.Ct. 632, 21 L.Ed.2d 567, without mentioning the conflict between this case and the prior decision of the Court of

Appeals for the Fifth Circuit in *Estate of R. L. Adame* v. *C.I.R.,* 320 F.2d 811 (C.A. 5, 1963).

The importance of this case lies not in its application to embezzled funds, which is a rather narrow and sordid area of tax law. But the *ex post facto* implications of the decisions of the Tax Court and the Court of Appeals are far reaching. Uniformity is of exceptional importance on the question of whether or not a taxpayer can, as a matter of law, in either a criminal or civil tax fraud case, be found to have had the requisite intent to defraud the Government for failing to include an item in gross income when the taxability of that item is not established or is highly debatable at the time the tax return is filed, or when the tax law is changed by statute or judicial decision after the return is filed. In the *James* case, the Supreme Court answered this question "no," and no court has refused to follow that decision until now.

The Courts of Appeal have consistently interpreted the *James* case as preventing civil or criminal tax fraud findings for failure to report embezzled funds in pre-*James* years. The Court of Appeals for the Fifth Circuit in *Estate of R. L. Adame* v. *C.I.R.*, supra, quite correctly determined that the *James* rule as to intent applied to prevent both civil and criminal tax fraud cases for pre-*James* years stating:

> "Whether the issue is the commission of the crime by fraudulent evasion of taxes, or fraudulent intent which would toll a statute of limitations, the issues are in essence the same." 320 F.2d at p. 814.

A fairly dramatic illustration of the *James* rule occurred in the Second Circuit in the case of *U.S.* v. *Dawson,* 400 F.2d 194 (C.A. 2, 1968), cert. den. 393 U.S. 1023, 89 S.Ct. 632, 21 L.Ed.2d 567, in which a taxpayer was found not guilty

of tax fraud for failure to report embezzled funds in a return filed before the *James* decision, but was found guilty of fraud for the return filed after the *James* decision. There were no significant differences between the acts of the taxpayer for the two years, but the District Court had properly charged the jury that if the only unreported income on the return filed prior to the *James* decision was embezzled, then the essential element of willfullness could not be present as a matter of law and a verdict of not guilty would be required.

In a later civil fraud penalty case, *Kahr* v. *C.I.R.*, 414 F.2d 621 (C.A. 2, 1969) the Second Circuit held that a taxpayer who failed to report embezzled funds as income prior to the Sureme Court decision in *James "could not, in legal contemplation, have formed the intent* to commit a tax fraud." (Emphasis added.) 414 F.2d at p. 627.

In *U.S.* v. *Critzer*, 498 F.2d 1160 (C.A. 4, 1974), the Defendant, an Eastern Cherokee Indian, had intentionally failed to report income from a business she conducted on Indian reservation property. The Fourth Circuit stated that the question of the taxability of that income was "a nice one," which it did not decide. However, as to the tax fraud issue, the Court reasoned as follows:

> "As a matter of law, defendant cannot be guilty of willfully evading and defeating income taxes on income, the taxability of which is so uncertain. *As a matter of law,* the requisite intent to evade and defeat income taxes is missing.
>
> "It is settled that when the law is vague or highly debatable, a defendant — actually or impliedly — lacks the requisite intent to violate it. Perhaps the most dramatic illustration of this principle is found in cases dealing with the taxability of embezzled funds." 498 F.2d at p. 1162.

In *Nordstrom* v. *U.S.*, 360 F.2d 734 (C.A.8, 1966), cert. den. 385 U.S. 826, 87 S.Ct. 59, 17 L.Ed. 2d 63, the Court of Appeals for the Eighth Circuit held that since the *James* decision occurred prior to the time the taxpayer's return was filed, fraudulent intent could be proven. In doing so, however, the Court stated that "the conviction of James himself was reversed simply because *at the time the return was filed, Wilcox* was the controlling law." 360 F.2d 734 at p. 736.

That the courts could not consider the factual record to determine fraud for failure to report embezzled funds in a pre-*James* return was, until the instant case, settled and not open to question. In *James* itself, two of the Justices dissented in part because they believed that the case should be remanded for a further factual determination. However, the Supreme Court reversed James' conviction with directions to dismiss, finding that willfullness could not be proven *as a matter of law.*

In the opinion in the instant case, the Court of Appeals felt that the *James* and *Adame* decisions permitted an independent determination of fraud not based upon the mere failure to report income. However, it is respectfully submitted that such a reading of *James* and *Adame* is incorrect and contrary to the decisions of all other appellate courts which have considered the question. Fraud is not committed except through the omission of specific income (embezzled funds) and if the omission of such funds cannot, *as a matter of law,* be fraudulent, then the taxpayer in failing to report such income cannot, *as a matter of law,* have formed the required intent to commit a tax fraud, regardless of his motive or the facts surrounding the omission. How can a taxpayer be said to have *intended* to evade taxes in omitting an item that was not taxable when the return was filed? Any tax counselor advising the exclu-

sion of items excludable from gross income under the law at the time the return is filed and the nonpayment of taxes on the non-taxable income would be subjecting his client to a tax fraud penalty or imprisonment if the law were subsequently changed. Neither the Court of Appeals for the Fifth Circuit nor the Tax Court should be permitted to do what this Court, and every other Court of Appeals, has said cannot be done.

III. The Court of Appeals has sanctioned the Tax Court's departure from the established rule requiring the Government to prove fraud.

Both the Court of Appeals and the Tax Court have in fact ignored the basic and essential requirement that the burden placed on the Commissioner of Internal Revenue is the burden to *prove*, by clear and convincing evidence, that income was omitted with the *specific purpose and intent* of evading a tax known (or believed) to be due. *Carter* v. *Campbell*, 264 F.2d 930 (C.A. 5, 1959). Instead they have in fact placed the burden on the taxpayer to prove his innocence of intent to defraud the U. S. Government of tax revenues.

The Court of Appeals in its opinion considered three "facts" as sustaining the Tax Court's ultimate finding of fraud:

1. The allegedly devious methods used to extract funds.
2. The reporting of taxable income received from Gulf Copper and Manufacturing Corporation; and
3. The alleged misrepresentation to the revenue agent.

Although the record is clear that the taxpayer employed "devious methods" to embezzle funds from his employer,

the record is equally clear that he employed no "devious methods" at all to conceal income from the Government. On the contrary, he deposited embezzled receipts (indeed, checks!) to his *only* bank account, thus creating a permanent and easily obtainable record.

Secondly, the taxpayer's reporting of the Gulf Copper and Manufacturing Corp. payments, (admittedly not embezzled), coupled with his not reporting the embezzled funds, was construed by the Court of Appeals to be *proof* of fraudulent intent. The Court of Appeals reasoned that the taxpayer knew his co-conspirator (PAMEW) was not reporting the embezzled funds on its return so he did not report them on his return. But there is nothing in the record to show what, if anything, the taxpayer knew about PAMEW's treatment of the embezzled funds on its return. The Tax Court's and the Court of Appeal's "finding" on this point is *not* a finding of fact of awareness by McGee based on the record, but an inference. As a matter of fact, PAMEW attempted to deduct the embezzled funds paid to taxpayer on its income tax return.

Finally, McGee's single exculpatory statement to a vague misleading inquiry by a revenue agent is simply not the same "material misrepresentation" required in other tax fraud cases, e.g. *Estate of Upshaw* v. *C.I.R.*, 416 F.2d 737 (C.A. 7, 1969) cert. den. 397 U.S. 962, 90 S.Ct. 2d 254. Certainly it would not support a charge of false swearing. See *U.S.* v. *Bush*, 503 F.2d 813 (C.A. 5, 1974) and *Paternostra* v. *U.S.*, 311 F.2d 298 (C.A. 5, 1962).

It is respectfully submitted that the Tax Court and the Court of Appeals misapprehended and misapplied the burden of proof placed on the Government in civil tax fraud cases. The Government's burden is to prove affirmatively, by clear and convincing evidence that the taxpayer harbored the specific intent to evade taxes in filing his

returns for the post-*James* years. The time such intent is to be tested is "the time the return is filed, not some earlier or later date." *Blaine S. Fox*, 61 T.C. 704, 717 (1974). Such burden is not satisfied by inference, suspicion, doubt or probability.

There is no reason whatsoever that the Government, when it has the burden of proof on an issue, should not at least be held to the same degree of proof that a taxpayer is. There is no doubt that if the burden had been on the taxpayer in this case and all he had done was make insinuations and inferences about the stipulated facts, there would have been a reversal on the basis of failure of proof. Suspicion of fraud, doubt as to intentions, reading between the lines — all do not satisfy the *Government's* strict burden of proof. It is admitted that what the taxpayer did was immoral, reprehensible, illegal and a breach of trust — but the immorality and illegality was directed against his employer, not against the U. S. Government. Where, as here, the burden is on the Government to prove fraud, this Court should not allow the Government to merely give the taxpayer a bad name, even a deserved bad name, and thereby sustain its burden. Such a departure from the established rule requiring the Government to prove fraud calls for the exercise, by this Court, of its power of supervision.

CONCLUSION

The judgment below is a unique departure from two rules. The first rule established clearly in tax law by this Court, and followed in every other Court of Appeals, is that a taxpayer cannot be found to have willfully omitted an item to defraud the Government of tax when the law making such item taxable is not established until after the return is filed. Even a taxpayer motivated by diabolical

duplicity cannot be found to have had the requisite intent to commit tax fraud by failing to report embezzled funds prior to the *James* decision. The second rule requires the Government to carry its burden of proof by at least the same quantum of evidence as would be required of a taxpayer if the burden were placed on him, as is customarily done in most tax cases. This Petition for a writ of certiorari should, therefore, be granted.

Respectfully submitted,

S. L. GREENBERG

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P. O. Box 3708
Beaumont, Texas 77704
(713) 838-2644

Of Counsel
J. MARTIN GREEN
P. O. Box 3708
Beaumont, Texas 77704

Attorney for Petitioner

CERTIFICATE OF SERVICE

I, S. L. GREENBERG, attorney for George C. McGee, Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that, on the ..... day of January, 1976, I served three copies of the foregoing Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit on the United States, by mailing three copies thereof, in a duly addressed envelope, with air mail postage prepaid, to the Solicitor General, Department of Justice, Washington, D.C., 20530.

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S. L. GREENBERG

APPENDIX "A"

GEORGE C. McGEE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 74–2006.

UNITED STATES COURT OF APPEALS,
FIFTH CIRCUIT.

Sept. 26, 1975.

Taxpayer who was responsible for maintenance of his employer's vessels and who arranged to have repairer submit invoices to employer containing charges for services not actually performed and who received payment of the excess charge appealed from decision of Tax Court, 61 T.C. 249, that the amounts received were taxable income and that Commissioner of Internal Revenue carried burden of proving fraud for purpose of imposition of additions to tax and lifting bar of statute of limitations. The Court of Appeals, Lynne, District Judge, held that the sums received by taxpayer from repairer during the years 1958 through 1963 constituted taxable income in each of such years; and that combination of the five devious methods employed by taxpayer in extracting kickbacks, the disparate treatment of illegal gains derived from ship repairer and another contractor, and the deliberate misrepresentation to revenue agent that taxpayer had received no money from repairer warranted inference of fraud.

Roney, Circuit Judge, specially concurring, filed opinion.
Affirmed.

Appeal from a decision of the Tax Court of the United States (Texas Case).

Before GOLDBERG and RONEY, Circuit Judges, and LYNNE, District Judge.

LYNNE, District Judge:

The focus of this appeal is on the contentions of appellant, George C. McGee (McGee) that the Tax Court[1] erred in its holding that the amounts received by him from Port Arthur Marine Engineering Works (PAMEW) in the years 1957 to 1963 were taxable income and that the Commissioner carried his burden of proving fraud under both sections 6501(c), 26 U.S.C. 6501(c)[2] and 6653(b), 26 U.S.C. 6653(b)[3] of the Internal Revenue Code of 1954. We affirm.

In its opinion the Tax Court thoroughly canvassed the facts developed upon stipulated and testimonial evidence.[4]

[1] 61 T.C. 249.

[2] 26 U.S.C. 6501(c) in pertinent part reads as follows:

za

(c) Exceptions.—

(1) False return.—In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

(2) Willful attempt to evade tax.—In case of a willful attempt in any manner to defeat or evade tax imposed by this title (other than tax imposed by subtitle A or B), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

• • • • • •

[3] 26 U.S.C. 6653(b) in pertinent part reads as follows:

• • • • • •

(b) Fraud.—If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment.

• • • • • •

[4] It is noteworthy that McGee did not elect to testify in his own behalf in the proceedings before the Tax Court.

They are severely capsulated herein to highlight our rationale.

Throughout the years in question McGee was Port Engineer for Gulf Oil Corporation (Gulf) in Port Arthur, Texas, and filed individual income tax returns with the District Director of Internal Revenue, Austin, Texas. He was responsible for maintenance and repairs of Gulf's ships and other marine vessels.

Within the scope of his authority for Gulf, he employed PAMEW to make repairs upon vessels which he had determined to have been necessary and which he supervised and directed. He received, examined and approved for payment invoices rendered by PAMEW to Gulf which were consistently paid by check payable to PAMEW.

With the cooperation of W. O. Nelson, the owner of PAMEW, he contrived a sordid scheme of "kickbacks". At McGee's request, invoices submitted by PAMEW contained either in whole or in part charges for services not actually performed. Such invoices were initialed by McGee to indicate his approval and were paid by Gulf. The excess over the true amount due, varying from five to fifty percent, was remitted to McGee as his share.[5]

[5] In the years in question, McGee received the following amounts by checks drawn on the bank account of PAMEW which he did not report on his income tax returns for those years:

Taxable Year	Receipts
1957	$10,511.41
1958	6,807.91
1959	6,917.77
1960	7,287.59
1961	6,898.61
1962	2,784.00
1963	2,800.00

In addition, McGee received from such source cash in 1957, in at least the amount of $2,183.61, and in 1958, in at least the amount of $1,191.75, also unreported.

Such payments were made to McGee in five ways: (1) in cash given to him in the offices of PAMEW's president; (2) by check drawn on PAMEW payable to and endorsed by him; (3) by check drawn on PAMEW payable to McGee and endorsed for deposit in McGee's bank account by PAMEW's president; (4) by check drawn on PAMEW payable to PAMEW's president but endorsed payable to McGee, and (5) by check payable to PAMEW's president, but endorsed for deposit to McGee's bank account. None of these payments were reported by McGee on his income tax returns for the years in question.

During the same period of time McGee employed in behalf of Gulf another marine contractor, Gulf Copper and Manufacturing Company (GCMC). As a condition of doing business with Gulf, GCMC was required to and did remit to McGee an agreed upon percentage of the proceeds of its invoices. Such invoices were not false or padded, but for work actually performed by it for Gulf. GCMC reported all payments made to McGee on Treasury Forms 1099 and, aware of this, McGee included such sums in his income tax returns.

In the course of an audit of his returns for the years in question, performed in 1965, McGee denied to the investigating revenue agent that he had received any funds from PAMEW.[6]

Against this factual backdrop, the starting point is *Commissioner of Internal Revenue* v. *Wilcox*, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752 (1946). Wilcox was a bookkeeper for a Nevada company. When its books were audited it was

[6] However, on November 27, 1963, Gulf filed a complaint in the United States District Court for the Eastern District of Texas seeking recovery of funds which, Gulf alleged, *inter alia*, McGee had obtained from it by fraud and breach of fiduciary duty. The action was ultimately settled for $70,000.00.

discovered that he had converted a substantial sum of money to his own use, which he frittered away in gambling. In affirming the Ninth Circuit's reversal of the Tax Court decision, the Court squarely held that embezzled money did not constitute taxable income.

Six years later, in *Rutkin* v. *United States*, 343 U.S. 130, 72 S.Ct. 571, 96 L.Ed. 833 (1952), the Court determined that money obtained by extortion was income taxable to the extortioner under Section 22(a) of the Internal Revenue Code. Rutkin had obtained a large sum of money from one Reinfeld by, among other pressures, threats to kill Reinfeld and his family. In affirming Rutkins conviction under 26 U.S.C. § 145(b) for willfully attempting to evade or defeat federal taxes, arising out of his failure to report such money on his income tax return, it reasoned that

> An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient *has such control* over it that, *as a practical matter, he derives realizable economic value from it. Burnet* v. *Wells*, 289 U.S. 670, 678, 53 S.Ct. 761, 764, 77 L.Ed. 1439; *Corliss* v. *Bowers*, 281 U.S. 376, 378, 50 S.Ct. 336, 337, 74 L.Ed. 916. That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, *even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it.* [Emphasis added].

Finally, it defused *Wilcox* by flatly stating: "We limit that case to its facts." 343 U.S. at 138, 72 S.Ct. at 576.

The last of the trilogy is *James* v. *United States*, 366 U.S. 213, 81 S.Ct. 1052, 6 L.Ed.2d 246 (1961). James, a union official, with another person, embezzled large sums of money during the years 1951 through 1954 from his employer-union and from an insurance company with which the union

was doing business. He failed to report these amounts in his gross income in those years and was convicted for willfully attempting to evade the federal income tax due for the years 1951 through 1954 in violation of Section 145(b) of the Internal Revenue Code of 1939, and Section 7201 of the Internal Revenue Code of 1954.

[1] *James* expressly overruled *Wilcox*. Implicit is its holding that the funds embezzled by James during the years 1951 through 1954 constituted taxable income in each of such years.[7] *A fortiori*, it compels us to hold, as we do, that the sums received by McGee from PAMEW during the years 1958 through 1963 constituted taxable income in each of such years.

Although the conviction of James was reversed, it does not follow that the Court limited the principles enunciated in its opinion to prospective application only. On the contrary, it referred to its definition of willfulness in *Holland* v. *United States*, 348 U.S. 121, 75 S.Ct. 127, 99 L.Ed. 150, as "involv[ing] a specific intent which must be proven by independent evidence and which cannot be inferred from the mere understatement of income." It concluded with the belief—"that the element of willfulness could not be proven in a *criminal prosecution* for failing to include embezzled funds in gross income in the year of misappropriation so long as the statute contained the gloss placed upon it by *Wilcox* at the time the alleged crime was committed." [Emphasis added]. 366 U.S. at 221, 81 S.Ct. at 1057.

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[7] That this Court so read *James* was made explicit in *Adame's Estate* v. *Commissioner of Internal Revenue*, 320 F. 2d 811, at 814 wherein after reference to James we stated

> Although the Court held that [the sum of $738,000 embezzled from his employer-union and an insurance company from 1951 through 1954] was taxable income to James • • •

If we were writing on a clean slate we would feel impelled to explore whatever differences there may be, both qualitatively and quantitatively, in the proof required to establish civil fraud and intent to evade tax which would toll the statute of limitations and justify additions to tax, on the one hand, and that required to prove willfulness in a criminal prosecution, on the other.

However, another panel of this Court has foreclosed this tempting judicial exercise. In *Adame's Estate* v. *C.I.R.*, 320 F.2d 811 (5th Cir. 1963), in a case remarkably similar to this on some of its facts, the Court categorically stated:

> Whether the issue is the commission of crime by fraudulent intent which would toll a statute of limitations, the issues are in essence the same. 320 F.2d at 814.

But that is not to say that *Adame's Estate* controls the result to be reached in the case *sub judice*. That Court explicated its precise holding as follows:

> We hold that the failure to declare such unlawful gains could not be evidence of fraudulent intent. *As there is no other evidence sufficient to support the Tax Court's findings* we reverse the assessment of deficiencies which are barred by the statute of limitations and the penalties for the years in question. [Emphasis added]. 320 F.2d at 812.

Matters stand differently here. We are instructed by *Commissioner of Internal Revenue* v. *Duberstein*, 363 U.S. 278, 80 S.Ct. 1190, 4 L.Ed.2d 1218 (1960), that:

> Where the trial has been by a judge without a jury, the judge's findings must stand unless "clearly erroneous." Fed.Rules Civ.Proc., 52(a). "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been

committed." *United States* v. *United States Gypsum Co.*, 333 U.S. 364, 395, 68 S.Ct. 525, 92 L.Ed. 746. The rule itself applies also to factual inferences from undisputed basic facts, *id.*, at 394, 68 S.Ct. 525, as will on many occasions be presented in this area. *Cf. Graver Tank & Mfg. Co.* v. *Linde Air Products Co.*, 339 U.S. 605, 609–610, 70 S.Ct. 854, 94 L.Ed. 1097. And Congress has in the most explicit terms attached the identical weight to the findings of the Tax Court. I.R.C., § 7482 (a). [Footnote omitted]. 363 U.S. at 291, 80 S.Ct. at 1200.

[2] The record of the proceedings in the Tax Court has been subjected to critical scrutiny. Recognizing that the Commissioner had the burden of proving fraud by clear and convincing evidence, that Court analyzed its subsidiary findings of fact which were summarized in the introduction to this opinion and made the ultimate finding of fact that he had proved fraud, without reliance on McGee's mere failure to report income, standing alone, as evidence of his fraudulent intent.[8] We hold that this finding of fact is not clearly erroneous and that the result reached is far from being contrary to the truth and right of the case.[9]

Independent record evidence upon which the Tax Court focused in its search for an elusive fraudulent intent may be severly capsulated:

[8] Based upon its findings of fact the Tax Court concluded that there were deficiencies in income taxes and addition to the tax due from McGee as follows:

Year	Income Tax	Addition to The Tax
1957	$9,368.18	$4,684.09
1958	6,329.27	3,164.64
1959	4,916.23	2,458.12
1960	5,886.94	2,943.47
1961	4,261.35	2,130.68
1962	2,353.81	1,176.91
1963	1,058.03	529.01

[9] *Cf. C.I.R.* v. *Welch*, 345 F. 2d 939, at 944 (5th Cir. 1965).

1. From the five devious methods employed by McGee in extracting kickbacks from PAMEW the Tax Court could properly infer that such methods were designed to conceal income from the government as well as from his employer.

2. From McGee's disparate treatment of illegal gains derived from GCMC and PAMEW the Tax Court could properly infer fraud with intent to evade tax. The former were reported because he knew that GCMC was reporting its payments to him on Treasury Form 1099. The latter he concealed with the knowledge that they were not being reported by PAMEW.

3. McGee's deliberate misrepresentation to the revenue agent in 1965 that he had received no money from PAMEW during the period in question was properly treated by the Tax Court as an indicium of his prior intent to evade taxes. *Estate of Upshaw* v. *Commissioner of Internal Revenue*, 416 F.2d 737 (7th Cir., 1969), *cert. den.* 397 U.S. 962, 90 S.Ct. 993, 25 L.Ed.2d 254 (1970). McGee's behavior in this regard may be contrasted to that of the taxpayer in *Toledano* v. *Commissioner of Internal Revenue*, 362 F.2d 243 (5th Cir. 1966), wherein the taxpayer's good faith cooperation with the Internal Revenue Service was cited as evidence from which absence of fraudulent intent might be inferred. *See also Powell* v. *Granquist*, 252 F.2d 56 (9th Cir. 1958).

[3] Cases pressed upon us by the taxpayer standing for the proposition that the presence of only one of the foregoing indicia of fraud, considered in isolation, is insufficient independent evidence of fraudulent intent are inapposite. It is the combination of these indicia which we conclude warranted the inference of fraud. *See Holland* v. *United States*, 348 U.S. 121, 139, 75 S.Ct. 127, 99 L.Ed. 150 (1954).

The judgment of the Tax Court is therefore affirmed.

Affirmed.

RONEY, Circuit Judge (specially concurring):

I concur, but on the ground that the moneys received by McGee were, and always have been, income under the *Rutkin* rationale. The facts show that McGee did not have rightful possession to money belonging to another that he diverted to his own use, the classic embezzlement reflected in *Wilcox*. The sums were paid to McGee for him to keep as his own. They constituted income under *Rutkin* whether or not *Wilcox* remained law. Therefore, I would not need *James'* overruling of *Wilcox* to support an affirmance of the deficiency assessment in this case. There is serious doubt in my mind that sums received on facts identical to *Wilcox* should be taxed as income during the years that *Wilcox* was on the books holding such not to be income. But since, in my view, the facts here clearly demonstrate taxable income different from that protected by *Wilcox*, I agree that the tax court is due to be affirmed on the deficiency income tax assessment and that the not clearly erroneous finding of fraud lifts the statute of limitations as a bar.

APPENDIX "B"

UNITED STATES TAX COURT

GEORGE C. MCGEE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 7787-70.

Filed November 20, 1973.

Petitioner was Port Engineer for Gulf Oil Corporation in Port Arthur, Tex., during the years 1957-1963 and as such was responsible for maintenance and repairs of Gulf's ships and other marine vessels. Petitioner arranged to have a marine contractor who worked on Gulf's ships inflate its invoices for work done, which petitioner approved for payment by Gulf. Gulf paid the invoices to the contractor and the contractor remitted prearranged portions of the excess charges to petitioner, who failed to report those amounts on his income tax returns.

Held, the amounts petitioner received from the contractor both before and after the decision in *James* v. *United States,* 366 U.S. 213 (1961), were taxable income.

Held, petitioner's failure to include amounts received from the contractor in gross income reported on his returns for each of the years 1957-1963 and his failure to pay tax thereon was due to fraud. Fifty percent additions to tax imposed under sec. 6653(b), I.R.C. 1954.

Held, petitioner's income tax returns for each of the years 1957-1963 were fraudulent with intent to evade tax. Assessment of deficiencies for those years not barred by statute of limitations.

S. Louis Greenberg, for the petitioner.

W. Read Smith, for the respondent.

DRENNEN, *Judge*: Respondent determined the following deficiencies in and additions to petitioner's Federal income tax.

Year	Deficiency	Additions under sec. 6653(b)
1957	$9,572.28	$4,786.14
1958	6,411.55	3,205.78
1959	5,274.36	2,637.18
1960	6,285.14	3,142.57
1961	4,518.26	2,259.13
1962	2,394.42	1,197.21
1963	1,058.03	529.01

Petitioner admits that he received amounts of money from the source mentioned below in each of the years 1957-1963 which he did not report on his tax returns for those years. Respondent concedes that the notice of deficiency was mailed after expiration of the statutory limitations period for all years except 1963. The issues are whether the unreported amounts received by petitioner were taxable income; if so, whether petitioner's failure to include those amounts in his returns for 1957-1963 and his failure to pay tax thereon was due to fraud so as to require imposition of the 50-percent additions to tax under section 6653(b), I.R.C. 1954, and whether petitioner's returns for each of those years were fraudulent with intent to evade tax so as to lift the bar of the statute of limitations for the years 1957-1962 under section 6501(c)(1). There is also an issue as to the amount of cash petitioner received in 1957 and 1958.

FINDINGS OF FACT

The stipulated facts are incorporated herein by this reference.

George C. McGee, petitioner, was a resident of Groves, Tex., at the time of the filing of the petition herein. For the taxable years 1957 through 1963, petitioner filed individual income tax returns with the district director of internal revenue, Austin, Tex.

In each of the above taxable years, petitioner was employed by Gulf Oil Corporation (Gulf) as its port engineer in Port Arthur, Tex. Petitioner's general duty was to oversee the performance of maintenance and repairs on ships, tankers, barges, and other of Gulf's marine vessels in the Gulf Coast area. Petitioner thus inspected incoming and outgoing vessels, determining what work, if any, was necessary, arranged to employ marine contractors and service establishments, and supervised and directed repair operations. Within the scope of his employment, petitioner received, examined, and approved for payment invoices rendered by contractors and service establishments. Petitioner would initial invoices he approved and deliver them to Gulf for payment. Gulf would issue checks payable directly to the contractors and service establishments, but would deliver the checks to petitioner for transmittal to the payees.

Two marine contractors hired by petitioner in the taxable years 1957 through 1963 were Port Arthur Marine Engineering Works (PAMEW) and Gulf Copper Manufacturing Company (GCMC).

Petitioner obtained payments from PAMEW and GSMC as a condition to each firm's doing business with Gulf.

Payments from PAMEW originated with invoices submitted by that firm which contained either in whole or in part charges for services not actually performed. Such invoices were made at petitioner's request, typed on PAMEW invoice forms by PAMEW personnel, initialed

by petitioner to indicate his approval for payment by Gulf, and taken by petitioner to Gulf for payment. Gulf never rejected or refused to pay such invoices, but always prepared checks payable to PAMEW. Petitioner would then either personally deliver Gulf's checks to PAMEW or, after notifying the latter, mail the checks to it. PAMEW would deposit the checks in its general bank account and pay to petitioner a previously arranged portion of each remittance; petitioner's share varied from 5 to 50 percent.

Payments to petitioner were made in five ways: (1) In cash, given to petitioner in the office of PAMEW's president; (2) by a check drawn on PAMEW payable to petitioner and endorsed by him; (3) by check drawn on PAMEW payable to petitioner and endorsed for deposit in petitioner's bank account by PAMEW's president; (4) by check drawn on PAMEW payable to PAMEW's president but endorsed payable to petitioner; and (5) by check payable to PAMEW's president, but endorsed for deposit to petitioner's bank account. One check payable to petitioner and two checks payable to the president of PAMEW but endorsed to petitioner totaling $2,455.86 were endorsed by an Alice Willingham as well as by petitioner.

In the taxable years at issue, petitioner received the following amounts by checks drawn on the bank account of PAMEW, which petitioner did not report on his income tax returns for those years:

Taxable year	Receipts
1957	$10,511.41
1958	6,807.91
1959	6,917.77
1960	7,287.59
1961	6,898.61
1962	2,784.00
1963	2,800.00

In the taxable year 1957 petitioner received cash in at least the amount of $2,183.61, and in 1958 in at least the amount of $1,191.72, from PAMEW, which petitioner did not report on his income tax returns for those years.

On November 27, 1963, Gulf filed a complaint in the U. S. District Court for the Eastern District of Texas, seeking recovery of funds which, Gulf alleged, *inter alia*, petitioner had obtained from it by fraud and breach of fiduciary duty. Petitioner filed an answer denying liability; however, the action ultimately was settled, petitioner agreeing to pay Gulf $70,000.

During the taxable years 1957 through 1963, GCMC paid sums to petitioner which it reported on Treasury Forms 1099 and which petitioner reported on his income tax returns for those years. GCMC did not receive any of the sums paid petitioner from false or padded invoices to Gulf, but from work it actually performed for Gulf.

In the course of an audit of his returns in 1965 petitioner denied to the investigating revenue agent that he had received any funds from PAMEW that he had not reported on his returns for the years here involved. During the years here involved petitioner had a checking account in a bank in Port Arthur, Tex. Respondent made an extensive but unfruitful search for other bank accounts of any kind in petitioner's name.

ULTIMATE FINDINGS

Petitioner realized ordinary taxable income from the amounts he received from PAMEW in each of the years 1957-1963, which he failed to report on his income tax returns for those years.

Petitioner's failure to include the above amounts in gross income reported on his returns for those years and his failure to pay tax thereon was due to fraud.

Petitioner's income tax returns for each of the years 1957-1963 were false and fraudulent with intent to evade tax.

OPINION

Petitioner admits that certain amounts of income were omitted from his returns for each of the years 1957 through 1963, but he does not admit that this income was taxable in the years 1957 through 1960, prior to the decision of the U. S. Supreme Court in *James* v. *United States,* 366 U.S. 213 (1961); he also questions the amount of such income received in the years 1957 and 1958. Petitioner contends that, because the notice of deficiency was mailed to petitioner more than 3 years after his returns for those years were filed, assessment of deficiencies for the years 1957 through 1962 is barred by the statute of limitations, sec. 6501(a), I.R.C. 1954;[1] also respondent has failed to carry his burden of proving fraud for any of the years 1957 through 1963 as required for the addition to tax under section 6653(b) of the Code. Respondent contends that the statute of limitations is inapplicable to the years 1957-1962 under section 6501(c) because the returns for each of those years were false or fraudulent with the intent to evade tax; also that a part of the deficiencies in tax for each of the years 1957-1963 is due to fraud so that the 50-percent addition to tax imposed by section 6653(b) should be assessed for each of those years.

The first issue is whether the unreported income received by petitioner from or through PAMEW in the years 1957-

[1] All section references are to the Internal Revenue Code of 1954 unless otherwise indicated.

1960 was taxable income; however, the issue of primary importance in the case is whether the omission of the items of income received by petitioner from PAMEW in each of the years 1957-1963 was due to fraud with intent to evade tax.

Petitioner admits that he received amounts from PAMEW, under the scheme described in our findings of fact, in each of the years 1957-1963 which he did not report on his returns, and admits that the amounts received in 1961-1963 were taxable income. However, petitioner contends that PAMEW was a vehicle through which he embezzled funds from Gulf, that until the decision of the Supreme Court in *James* v. *United States, supra*, in 1961, embezzled funds did not constitute taxable income, and that because *James* by its own terms is not to be applied retrospectively, petitioner cannot be considered to have understated his income by the amounts received in 1957-1960, whether or not his intent was fraudulent.

In *Commissioner* v. *Wilcox,* 327 U.S. 404, 408-9 (1946), the Supreme Court held that proceeds of embezzlement did not constitute taxable income to the embezzler.

Six years later, in *Rutkin* v. *United States,* 343 U.S. 130 (1952), the Court held that extorted funds did constitute taxable income to the extortionist; *Wilcox* was held limited "to its facts." 343 U.S. at 138.

Finally, in *James* v. *United States, supra* at pp. 221-2, the Court definitively overruled *Wilcox*:

> We believe that *Wilcox* was wrongly decided and we find nothing in congressional history since then to persuade us that Congress intended to legislate the rule. Thus, we believe that we should now correct the error and the confusion resulting from it, certainly if we do so in a manner that will not prejudice those

who might have relied on it. [Cit. omitted.] We should not continue to confound [*sic*] confusion, particularly when the result would be to perpetuate the injustice of relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through theft while honest people pay their taxes on every conceivable type of income.

But, we are dealing here with a felony conviction under statutes which apply to any person who "willfully" fails to account for his tax or who "willfully" attempts to evade his obligation. In *Spies* v. *United States,* 317 U.S. 492, 499, the Court said that § 145(b) of the 1939 Code embodied "the gravest of offenses against the revenues," and stated that willfulness must therefore include an evil motive and want of justification in view of all the circumstances. [Cit. omitted.] Willfulness "involves a specific intent which must be proven by independent evidence and which cannot be inferred from the mere understatement of income." *Holland* v. *United States,* 348 U.S. 121, 139.

> We believe that the element of willfulness could not be proven in a criminal prosecution for failing to include embezzled funds in gross income in the year of misappropriation so long as the statute contained the gloss placed upon it by *Wilcox* at the time the alleged crime was committed. Therefore, we feel that petitioner's conviction may not stand and that the indictment against him must be dismissed.

Petitioner asserts that *James* by its own terms may not be applied retrospectively to find that he fraudulently understated his income for the years 1957 through 1960. *James'* language, however, makes clear that petitioner's assertion properly applies at most only to the issue of fraudulent intent and not to the question whether funds petitioner asserts he embezzled were in fact income before *James* was decided. Where no question has existed of willfulness or fraudulent intent, lower Federal courts have recognized that *James* may be applied retrospectively to sustain deficiencies based on unreported sums embezzled before 1961. See *Geiger's Estate* v. *Commissioner,* 352 F. 2d 221, 228 (C.A. 8, 1965); *Adame's Estate* v. *Commissioner,* 320 F. 2d 811, 814 (C.A. 5, 1963), affirming in part and reversing in part 37 T.C. 807; *Marvin E. Nerem,* 41 T.C. 338, 344 (1963). As noted in *Marvin E. Nerem, supra,* see 41 T.C. at 344, such decisions are in accord with the general policy that —

> The effect of • • • subsequent [judicial] decisions is not to make a new law but only to hold that the old law always meant what the court now says it means. The court has power to construe a legislative act, but it has no power by change in construction to date its passage as a law from the time of the later decision. • • • [*Fleming* v. *Fleming,* 264 U.S. 29, 31-32 (1924).]

We hold, therefore, that petitioner's returns for the years 1957 through 1960, as well as those for 1961 through 1963, did understate what was in fact his taxable income.

The crucial question is thus whether such understatements were fraudulent with intent to evade tax. As to the years 1961 through 1963, petitioner attacks only the sufficiency of the evidence, see *infra.* As to 1957 through 1960, however, petitioner's position is that *James* may not be applied retrospectively on the issue of intent and that if his improper receipt of funds in the years 1957 through 1960 was by embezzlement, he could not, as a matter of law,[2] have harbored fraudulent intent when he failed to report such receipts.

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[2] See *Adame's Estate* v. *Commissioner,* 320 F. 2d 811 (C.A. 5, 1963), affirming in part and reversing in part 37 T.C. 807, and *Kahr* v. *Commissioner,* 414 F. 2d 621 (C.A. 2, 1969).

We must, perforce, decide whether the Supreme Court decision in *James* prohibits a finding in this case that for the years 1957-1960 petitioner's failure to report the amounts he received from PAMEW in his tax returns was fraudulent with intent to evade tax. We must keep in mind the particular circumstances of this case and the fact that we are concerned here with proof of civil fraud rather than the criminal tax evasion involved in the *James* case which requires proof of willfulness beyond a reasonable doubt. The opinion in *James* v. *United States, supra,* stated only that:

> [T]he element of willfulness could not be proven in a criminal prosecution for failing to include embezzled funds in gross income * * * so long as the statute contained the gloss placed upon it by *Wilcox* at the time the alleged crime was committed.

Petitioner relies heavily on *Adame's Estate* v. *Commissioner, supra,* a case decided by the Court of Appeals for the Fifth Circuit,[3] to which an appeal in this case would normally lie. (See *Jack E. Golsen,* 54 T.C. 742 (1970), in which this Court adopted the rule that it would follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals alone). While we doubt that *Adame's Estate* is squarely in point because of the difference in facts, we certainly must analyze it carefully to determine whether it supports or would prohibit the conclusion we reach here. We find it to be neutral as a directive to the correct conclusion in this case.

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[3] We note that the majority opinion in *Adame's Estate* was written by Chief Judge Lumbard of the Second Circuit, joined in by Judge Brown of the Fifth Circuit. Judge Hutcheson of the Fifth Circuit dissented.

In *Adame's Estate* the taxpayer, who was a county superintendent of schools, devised a scheme to defraud the school districts by writing school district checks for more than the cost of supplies and pocketing the excess. In reversing this Court, 37 T.C. 807, the appellate court held that in the light of *James,* the failure to declare such unlawful gains (in the years 1948-1953) could not be evidence of "fraudulent intent" and that whether the issue is the commission of crime by fraudulent evasion of taxes, or fraudulent intent which would toll a statute of limitations,

> it would be equally improper to hold that the taxpayer's failure to declare monies was sufficient basis for inferring fraudulent intent when in both cases the law as it was understood at the time did not require him to report the monies as taxable income.

The court pointed out that there was no other evidence sufficient to support our findings, and a perusal of our opinion in *Adame's Estate* reveals that there was little evidence of fraud except the repeated failure to report the illegally obtained income. Here, as hereinafter pointed out, there is additional evidence of fraudulent intent.

We interpret the Court of Appeals opinion in *Adame's Estate* to mean that the failure to report embezzled income alone should not be used as evidence of fraudulent intent prior to the decision in *James.* We do not believe that it stands for the proposition that fraudulent intent, for civil tax purposes and the statute of limitations, in failing to report income illegally obtained by means other than embezzlement, cannot be proven by other evidence; or, necessarily, that fraudulent intent in failing to report embezzled income cannot be proven by other evidence.[4] We believe

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[4] But compare *Kahr* v. *Commissoner, supra,* which held that the taxpayer, by failing to report funds embezzled, could not, in legal contemplation, have formed the intent necessary to commit tax fraud

that *Adame's Estate's* application of the Supreme Court's statement in *James* is consistent with the result intended to be accomplished there and does not distort the equitable doctrine espoused therein.

In *James* the Court had before it a taxpayer who had been convicted of criminal tax evasion for failing to report as income funds which he had pleaded guilty to embezzling. The Court emphasized that the criminal tax statute requires proof of willfulness, and the essence of its decision was that willfulness could not be established under the criminal standard of proof beyond a reasonable doubt for pre-*James* years when the apparent state of the law then allowed innocent nonreporting of embezzled funds. In contrast, the purpose of the statutes providing for an unlimited period of assessment and for a 50-percent addition to tax because of fraud in a tax return is not to impose a penalty—punishment, if appropriate, is provided by section 7201, *et seq.* The rationale, rather, is to protect the revenue and the Government against the consequences of the probable efforts to conceal his receipts forever of a taxpayer motivated by an intent to evade taxes. See *Helvering* v. *Mitchell,* 303 U.S. 391, 401 (1938). The purpose of *James* was to preclude criminal penalties for non-reporting of embezzled funds in pre-*James* years, not, as shown *supra,* to allow pre-*James* embezzlers to escape paying the full amount of taxes they rightfully owe. Our interpretation of *Adame's Estate* and our decision in the instant case are in accord.

In addition, in *James* the Court defined willfulness as including "an evil motive and want of justification in view of all the circumstances."[5] On the other hand, fraud within

[5] See statement of Mr. Justice Blackmun, in his opinion as a Circuit Judge in *Geiger's Estate* v. *Commissioner,* 352 F. 2d 221, at p. 228, in discussing the prospective application of *James*: "This, however, does not prevent the application of James to a situation where willfulness is not a factor. The civil non-fraud tax liability of the Geigers is such a situation."

the meaning of the statutes now at bar has been held by the Fifth Circuit and this Court to mean "actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax *believed* to be owing. [Emphasis supplied.]" *Mitchell* v. *Commissioner,* 118 F. 2d 308, 310 (C.A. 5, 1941). See also *Marko Durovic,* 54 T.C. 1364, 1398 (1970). There has been some confusion in the definition of civil fraud, because some courts have substituted the word "known" for the word "believed" in the above quotation.[6] The Fifth Circuit has been rather consistent, but not entirely, in using the definition using the word "believed." See *Lee* v. *United States,* 466 F. 2d 11 (C.A. 5, 1972), and *Webb* v. *Commissioner,* 394 F.2d 366 (C.A. 5, 1968). But see *Tomlinson* v. *Lefkowitz,* 334 F. 2d 262 (C.A. 5, 1964). We recognize that the two terms, "believed" and "known", have been used interchangeable at times without harm, but we believe the use of the correct word "believed" is important in deciding the question we have before us because of the peculiar circumstances.

Under the definition prevalent in the Fifth Circuit and in this Court, it is enough that a taxpayer intends to evade

[6] It may be noted that the definition of fraudulent intent contained in *Kahr* v. *Commissioner, supra* (using the word "knows") appears to be the result of successive miscitations by several courts of the definition given by the Fifth Circuit in *Mitchell* v. *Commissioner,* 118 F. 2d 308 (C.A. 5, 1941). *Powell* v. *Granquist,* 252 F. 2d 56 (C.A. 9, 1958), cited *Mitchell* but added to *Mitchell's* definition the word "known" in parenthesis: "a tax *believed* (known) to be owing." (Emphasis added.) *Irolla* v. *United States,* 390 F. 2d 951 (Ct. Cl. 1968), citing *Mitchell,* removed the parenthesis and reversed the order of the words: "purpose to evade a tax *known or believed* to be owing." (Emphasis added.) Finally, *Kahr* (C.A. 2, 1969) removed the word "believed" altogether citing *Powell* and *Irolla* but not mentioning *Mitchell*: "an intent to evade taxes which the taxpayer *knows* are owed the Government." (Emphasis added.) This may help explain the narrow approach taken by the Second Circuit in applying *James* in *Kahr.*

taxes which he believes are owed the Government. That the rationale behind the addition to tax for civil fraud is remedial and not punitive, as *supra*, is convincing that the definition using the term "believed" is correct. In cases such as the one at bar, the revenue may be protected and the Government indemnified for extra expense only if the intent to evade taxes is measured by *belief* that taxes are being evaded rather than by *knowledge* that they are. This distinction in the meaning of the word "fraud" is important in this case because of the confusion in the law of Texas and the uncertainty in the law generally as to what constitutes embezzlement.

It would be practically impossible for respondent to prove that petitioner "knew," in the legal sense, that the amounts he received from PAMEW were taxable income, and that tax was due thereon. *Wilcox* held that embezzled funds were not taxable in the year appropriated. *James*, upon which petitioner relies, held that willfulness could not be proven for failing to include embezzled funds in gross income while *Wilcox* was viable. Furthermore, by the time petitioner filed his returns for the years here involved, the Supreme Court had decided *Rutkin* v. *United States*, *supra*. In *Rutkin* the Court held that money obtained by extortion was taxable income and affirmed the conviction of the taxpayer for willfully attempting to defeat and evade income taxes by failing to report such income. In doing so, the Court concluded that unlawful gain, as well as lawful gain, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it; and that unlawful gains secured by fraud of the taxpayer are taxable. The Court found it unnecesary to consider *Wilcox* because of the difference in factual situations involved, but limited *Wilcox* to the facts in that case. For respondent to prove fraudulent

intent under *James*, or under the definition of those courts which have used "knows" instead of "believes," he would have to prove by clear and convincing evidence that petitioner had examined the statutes and the cases and concluded either that *Rutkin* had totally vitiated *Wilcox*, as the Supreme Court subsequently decided in *James*, or that his activities did not constitute "embezzlement," see *infra*. Such a burden would clearly be impossible to meet, whereas it would be feasible for respondent to prove that, whatever the state of the law, petitioner in fact *believed* his improper receipts to be taxable and accordingly took steps to conceal those receipts from the Government forever.

Our conclusion here is buttressed by the existence of confusion in Texas law and uncertainty in the law generally as to what constitutes embezzlement.[7] We think that under both the laws of Texas[8] and the general principles of embezzlement enunciated by the Federal courts after *Wilcox*, petitioner's activities by which he came into possession of the funds at issue here more closely resembled "swindling" than embezzlement. There is at least sufficient uncertainty that it would be unreasonable to assume without inquiry that petitioner believed his activities to be embezzlement so he could not, in legal contemplation, have had the

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[7] See fn. 5 to Mr. Justice Blackmun's opinion in *Geiger's Estate* v. *Commissioner*, *supra*.

[8] Uncertainty exists whether Texas law should govern whether petitioner's acts constituted embezzlement within the meaning of *Wilcox* and *James*. Reference to State law regarding embezzlement was made in *Wilcox* itself and in *United States* v. *Jannsen*, 339 F. 2d 916, 918 (C.A. 7, 1964). But in *Marienfeld* v. *United States*, 214 F. 2d 632 (C.A. 8, 1954), the Eighth Circuit flatly rejected arguments that State embezzlement statutes should be applied or that *Wilcox* intended to require reference to State laws in this context. In accord is *United States* v. *Wyss*, 239 F. 2d 658 (C.A. 7, 1957).

intent to evade taxes by failing to report the amounts received.[9]

Article 1534 of the Texas Penal Code provides, with respect to embezzlement, that if any officer, agent, or employee of a corporation or private person —

> shall embezzle, fraudulently misapply or convert to his own use, without the consent of his principal or employer, any money * * * of such principal or employer which may have come into his possession or be under his care by virtue of such office, agency or employment, he shall be punished * * *.

Article 1545 of the Penal Code defines "swindling" as:

> [T]he acquisition of * * * money * * * by means of some false or deceitful pretense or device, or fraudulent representation, with intent to appropriate the same to the use of the party so acquiring * * *.

The Texas Courts have defined embezzlement as the fraudlent appropriation of the personal property of another by one to whom it has been entrusted, *Leonard* v. *State*, 7 Tex. Crim. R. 417 (1879), while to constitute swindling, they require that some false pretense as to an existing fact or past event be made in order to obtain the property, *Johnson* v. *State*, 41 Tex. 65 (1874), and in *Akers* v. *Scofield*, 167 F. 2d 718 (C.A. 5, 1948), the court, in finding a swindle, stated that the distinction between embezzlement and swindling is that in the former title to the property acquired never passes while in the latter title does pass.

[9] We think the distinction between embezzlement and misappropriation of funds by other illegal means is important in this context, where we are trying to decide whether petitioner could have had a fraudulent intent while *Wilcox* was viable, because the rationale of the *Wilcox* opinion likened embezzlement to a loan, where there is an acknowledged obligation to repay. We find no such similarity present in the circumstances in this case.

In this case while it is true that petitioner was an employee of Gulf by virtue of his employment that he was able to activate the scheme under which he obtained the funds, he did not appropriate the funds directly to himself; he induced Gulf to pay excessive amounts to PAMEW by use of false invoices indicating that more work had been done than was actually done. When Gulf paid the excessive amounts to PAMEW, the latter deposited the funds in its own bank account and title passed to PAMEW. Petitioner then received a part of the excessive funds from PAMEW. While petitioner's activities may have technically constituted embezzlement as well, it seems clear that the funds were obtained through false representation which constituted a swindle.

Wilcox, again, dealt only with embezzlement, which, as noted above, seems unlikely to have been the exact means by which petitioner obtained the funds which he failed to report. As *supra*, the tax years here involved came after the Supreme Court had decided *Rutkin* which undercut the rationale of *Wilcox* and limited that decision to its facts. It was in the climate of the law created by the combination of *Wilcox* and *Rutkin*, not in the climate of *Wilcox* alone, that petitioner would have had to form the belief that the funds he received from PAMEW were nontaxable in order to escape liability here.[10] Because of the considerable doubt that petitioner received the unreported funds through embezzlement as used in *Wilcox*, and because *Rutkin* limited *Wilcox* to its own facts, we think it was perfectly possible that, "in legal contemplation," petitioner could have had the intent to evade taxes that he believed to be due when he failed to report this income on his returns. We see no reason to extend the equitable doctrine used by the

[10] Petitioner did not testify at the trial of this case so we have no direct evidence of his actual state of mind.

Supreme Court in *James* beyond the bounds we believe it was intended to encompass.

Since we have concluded that *James* does not prohibit a finding of fraudulent intent in this case, we now must turn to the evidence to determine whether fraud has been proven. Respondent has the burden of proving fraud by clear and convincing evidence. We find that he has done so, even without reliance on petitioner's mere failure to report the income as evidence of his fraudulent intent, which may (or may not) be prohibited by *Adame's Estate* v. *Commissioner, supra.*

It is clear from the evidence that petitioner devised a scheme to swindle and defraud his employer, Gulf, and that he carried out this scheme during the years 1957-1963 with the cooperation of W. O. Nelson, the owner of PAMEW[11] Petitioner has admitted that he received funds during those years as a result of that scheme, which he did not report on his tax returns. It also appears, by inference at least, that petitioner kept no record of these receipts or transactions; the evidence shows that he denied receiving any such funds to the revenue agent who audited his returns for the years involved. While evidence that a taxpayer was attempting to defraud another in a business transaction may not be direct evidence of fraud with intent to evade tax, see *Toledano* v. *Commissioner,* 362 F. 2d 243, 247 (C.A. 5, 1966), the Court is entitled to consider such evidence along with other evidence in determining the intent of the taxpayer in doing certain acts, because it is a fair inference that a man who will misappropriate another's funds to his own use through misrepresentation and concealment will not hesitate to misrepresent and conceal his receipt of those same funds from the Government with intent to evade

[11] W. O. Nelson died several months before the trial of this case.

tax. *Rogers* v. *Commissioner,* 111 F. 2d 987 (C.A. 6, 1940). The legal relevancy of such evidence is based upon logical principles which go to negate innocent intent. *United States* v. *Bridell,* 180 F. Supp. 268 (N.D. Ill., E.D. 1960); *Pappas* v. *United States,* 216 F. 2d 515 (C.A. 10, 1954).

We also find significance in the fact that petitioner received kickbacks from PAMEW in cash which could not be identified in his accounts or in cash deposits to his bank account. The receipt of cash rather than checks from PAMEW would be unimportant in petitioner's efforts to conceal his fraud from Gulf, but it would be important in concealing his income from the Government. Weight can also be given to the fact that petitioner reported the kickbacks he received from GCMC, which reported these payments to the Government on Treasury Forms 1099. Petitioner argues that this was done because GCMC received no excess funds from Gulf and petitioner knew that non-embezzled kickbacks were taxable income even under *Wilcox.* However, we note that petitioner continued to treat the receipts from GCMC and PAMEW differently for tax-reporting purposes even after *James* had removed the distinction, taxwise, between embezzled funds and funds unlawfully obtained in other ways. We think it is more logical to assume that petitioner reported his receipts from GCMC prior to 1961 on his tax returns because he knew that the Government had notice of them but that he did not report his receipts from PAMEW because he thought he could conceal them from the Government as well as Gulf.

And finally, petitioner continued failing to report his income from PAMEW for several years after the *James* case was decided, which should have removed any doubt from his mind, even in legal contemplation, that those funds were taxable income. Such a consistent pattern of conduct with regard to the income received from PAMEW

both before and after the *James* decision is quite convincing that petitioner was not relying on the possibly nontaxable nature of the income prior to *James* in failing to report that income on his returns, but rather, that he was attempting to conceal that income with intent to evade tax. If petitioner was relying on *Wilcox* in not reporting the income he received from PAMEW, he had ample opportunity to so advise the revenue service and this Court.

We conclude from the record as a whole that respondent has carried his burden of proving fraud under both sections 6501(c) and 6653(b). This is particularly true with regard to the years 1961-1963 when petitioner could not possibly have been relying on *Wilcox* and the rationale of *James*, and consideration is given to the repeated omissions of substantial amounts of taxable income as additional evidence of fraudulent intent. See *Estate of Millard D. Hill*, 59 T.C. 846, 856 (1973); *Anderson* v. *Commissioner* 250 F. 2d 242 (C.A. 5, 1957); and *Bryan* v. *Commissioner*, 209 F. 2d 822 (C.A. 5, 1954). Hence, assessment of the deficiencies for the years 1957-1963 is not barred by the statute of limitations; and the 50-percent additions to tax determined to be due by respondent for each of those years is sustained. The purpose of the addition to tax is well served in this case: The precise amount by which petitioner's income was understated in the years in question appears still to be uncertain, and the record shows that the Government was indeed caused extra expense in attempting to undo petitioner's efforts at concealment. The addition is thus appropriate to protect the revenue and indemnify the Government.

As to the amount of the deficiencies asserted by respondent, petitioner's only challenge is to the size of the cash payments respondent determined petitioner received from PAMEW. Petitioner's assertion that he received no cash

at all is contradicted by the record. While petitioner made some effort to rebut respondent's determination with reference to several cash payments reflected on PAMEW's books, we do not find that he has succeeded in showing that respondent's determination in this regard was arbitrary or unreasonable or in overcoming the presumptive correctness of respondent's determination; thus, respondent's determination must stand. *Welch* v. *Helvering*, 290 U.S. 111 (1933); Rule 32, Rules of Practice, United States Tax Court.

Because of certain concessions made by the parties,

Decision will be entered under Rule 50.

APPENDIX "C"

26 U.S.C. 6653(b) in pertinent part reads as follows:

• • • •

(b) Fraud. — If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment.

• • • •

26 U.S.C. 6501(c) in pertinent part reads as follows:

• • • •

(c) Exceptions —

(1) False return. — In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

(2) Willful attempt to evade tax. — In the case of a willful attempt in any manner to defeat or evade tax imposed by this title (other than tax imposed by this subtitle A or B), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

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